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Comments on Richard Zeckhauser's *Investing in the Unknown and Unknowable*

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Richard Zeckhauser's important paper "Investing in the Unknown and Unknowable" provides a very different perspective on the investment process than the approach taken in either standard treatments of financial economics or more recent behavioral finance approaches. He focuses attention on the very large class of investments that are one-off and whose payoffs are not just difficult to predict, but have a range of possible outcomes that is difficult to enumerate. Such an emphasis is surely welcome. Any economist, particularly one who has not had extensive real world experience, will learn a great deal from this paper.

While much of the paper is directed at providing investment advice to its readers, its significance goes far beyond the investment process. Investment decisions are among the easiest for economists to study because the objective—making money—is clear, allowing success and failure to be easily judged. Much more consequential decisions, such as whether to invade Iraq, how to combat global warming, choosing whom to marry or how many children to have or what house to buy, have important unknown and unknowable aspects as well. And so lessons learned about how investment decisions and how they are and should be made are significant far beyond the field of finance.

In my comments on this paper, I will focus first on the investment advice contained within and then conclude with a broader reflection on the implications of Zeckhauser's analysis. I have no doubt that the vast majority of us would do very well to take investment advice from Richard Zeckhauser. The examples cited in his paper are, I suspect, not isolated. The same attributes that make him a world class bridge player contribute to his great shrewdness in making investment decisions.

Investment Advice

I have less confidence in Zeckhauser's maxims as guides for individual investors. Consider as a first example his valid observation that there is a tendency to underestimate the range of outcomes of investments and his inference that investments with limited loss possibility and very large positive upsides may therefore be good ones. The theory is good but the advice in most cases I suspect is not. Buying out of the money options or betting on long shots at the track would seem to be this kind of investment and yet large literatures demonstrate that these are losing strategies.

The objection, I suppose, is that listed options or bets at the track are not really UU investments of the kind contemplated in Zeckhauser's maxims. A better example of the kind of thing Zeckhauser has in mind is venture capital investments. But here too, history is not very congenial. Outside of the returns earned by a few investors with great acumen—the venture capital equivalents of Neff and Buffett—the returns of the sector have not been impressive. Those of us who lack access to the Kleiner-Perkins's of this world are probably better off sticking with our index funds than trying to make our own venture capital investments.

I have even less confidence in the advice that investors should try to make "sidecar" investments by partnering with those with specific skills or knowledge they lack. No doubt this is a great strategy with the right friends. But it is also the essence of what most con men do. They convince their mark that he has access to a great, unique, high payoff opportunity. The reason Zeckhauser's UU investments often can carry a high return is that they are indistinguishable ex-ante to most observers from cons or from investments that are ethical but being overly promoted by those with complementary skills.

So how does one choose potential sidecar investors? The ideal investment partner is one who brings special opportunities out of loyalty but to whom you feel no obligation. This may be a very small set. Family and friends are loyal and may present opportunities but may be hard to refuse. The motives of those where ties are less close are more suspect.

On balance, my guess is that the average person with wealth is better off following advice like David Swensen's that emphasizes diversification and containing transactions costs rather than trying hard to fish in the UU pond.[1] In thinking about Zeckhauser's anecdotes and advice, I am reminded of a question Paul Samuelson once posed. Suppose that research was done that accurately established that 10% of alcoholics could safely drink again? Would its dissemination be socially desirable?

Indeed it seems to me that going beyond the investment area, Samuelson's question is relevant in thinking about a variety of areas of policy that involve the unknown and the unknowable. Consider for example industrial policy. The ARPA-net program that ultimately turned into the internet was surely an example of a great public UU investment. And almost certainly industrial policy in East Asia had some important UU successes. Does it follow that the public sector should be further encouraged to make UU investments? I rather doubt it. Here too, I suspect that isolated successes should not unduly license experimentation of a problematic sort.

An additional suggestion in Zeckhauser's paper is that investors should not be deterred from entering into areas where there is ambiguity or in certain circumstances where others are more knowledgeable than they are. There certainly are situations where investors can profit from selling "ambiguity" insurance. Yet here too, I wonder about the general wisdom of following his advice. Take as an example Zeckhauser's apparently successful Gazprom investment. As he recognizes, it was a good investment if one could be confident

[1] Swensen, David F. *A Fundamental Approach to Personal Investment*. New York: Free Press, 2005.

that wealthy Russians really were putting their money in and that there would be no discrimination against foreigners factored into the price at which one could exit the investment. The question is whether most people confronted with this investment possibility could judge these factors more accurately than the market price incorporated them. Here I am skeptical.

My instincts run to the conventional emphasis on diversification and minimization of transactions costs. Beyond this I would suggest a single question that investors should ask in considering investments where ex-ante returns and risks are not easily quantified. “If I am buying, someone else is selling. Why are they selling in a way that will permit me to earn an excess return?” If the question has a compelling answer, invest. If not, stay away. There may be compelling answers in terms of their desire to do me a favor, their need for liquidity, their need to diversify or other circumstances. But in the absence such answers, I suspect one is well advised to steer clear.

Unknown and Unknowable

Whatever the efficacy of Zeckhauser’s investment advice for those who do not have all his gifts, his paper points up profoundly important issues for economic analysis. It may not be an exaggeration to assert that the most important decisions that we make as individuals, that businesses make in setting their strategy, or that governments make in choosing policy involve the unknown and unknowable. Standard decision theory has little to say about who to marry or where to live. The theory of capital budgeting has little to contribute to a company’s decision about a major acquisition or strategy change. And cost-benefit analysis may help judge individual regulations but it has little to say about how to approach China or Islamic terrorism in the 21st century.

And yet we have little in the way of insights from the either theoretical or empirical study to guide us with respect to these decisions and how they can be made more wisely. I hope that future work will fill this gap and improve the quality of the decisions that we all make.